Report of
Kenneth L. Casavant

Costco Wholesale Corporation v. Hoen, et al.
No. CV04-0360P

June 3, 2005

1) I am an agricultural economist in the School of Economic Sciences at Washington State University. I received my Ph D from Washington State University in 1971, after having received my Bachelor of Science and Master of Science from North Dakota State University in 1965 and 1967, respectively. I have been on the faculty of Washington State University for 36 years where I teach and conduct research in food economics and marketing. My areas of teaching are in management, marketing, industrial organization, pricing and policy. My area of research interest is in marketing of food, especially logistics and transportation, and other policy aspects of the marketing functions.

2) I have served in numerous positions providing advice in policy and program implementation in the state and Federal government. I was a Council member for the Pacific Northwest Power and Planning Council, appointed by Governor Lowery to represent the state of Washington. I have served on the Governor's Natural Resource Cabinet, as a Council member for the city of Pullman, on the Agricultural Marketing Taskforce for the United States Department of Agriculture, on the State Transportation Policy Plan for the Washington State Department of Transportation and on the Boards of Directors of various institutions in the region.

3) I have won numerous teaching awards and research awards at the local, regional and national level. I was honored to receive the R. M. Wade Award from my

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University and the Outstanding Teacher award from the American Agricultural Economics Association and to be elected a Fellow of the National Association of Colleges and Teachers of Agriculture. Recently I received a Best Paper Award from the Journal of Applied Business Research and an Honorable Mention for Published Research from the American Journal of Agricultural Economics. Last year I received a special honor when I was asked to give the annual Distinguished Faculty Address for my University. This is the oldest of the University's awards, and the only award selected by the entire faculty. In the same year I received the Sahlin Distinguished Award for Public Service to Washington State University. See my vitae for these and other awards and honors over my career.

4) I have published widely, with over 300 publications, more than 150 presentations at scholarly conferences, workshops, etc., several textbooks and eight chapters in other books, many dealing with the economics of applied decision making and policy evaluation. I have consulted as a marketing economist for a large number of national and international clients located throughout the United States and in Zimbabwe, Mali, the Philippines, Taiwan, Japan, Portugal, China, Sierra Leone, and Malawi among other countries. See my vitae for a listing of consultant activities and assignments.

5) I have served as an expert witness in various cases, but none within the past five years. See my vitae for a listing of consultancies, legal cases and others, and my participation.

6) In preparing my opinions in this case, I have considered, and in some cases relied on, many articles in the academic literature published in scholarly journals; interviews conducted during the work on this case; historical material and texts; filings and pleadings in this and other cases; and presentations by individuals in academic conferences dealing with the issues presented by this case. The great bulk of these materials focus on a) the price elasticity of demand for alcohol, in

differing sub-markets, b) the impact of alcohol abuse on individuals and subsets of the market, c) the societal costs of alcohol, both in general and relative to abuse, d) the role played by distributors in the marketing economy, and e) the impact of regulation on the normal functions performed by the market. See appendix 1 for a listing of the articles and materials I considered and reviewed.

7) Time and effort spent to investigate, evaluate and render an opinion as an expert witness in this case is billed at $200 per hour, plus expenses. These activities include background research, review of relevant academic research material and testimony/filings of others in relevant cases. Time and effort spent preparing for, and in, depositions and testimony will be billed at $300 per hour.

8) ~~My work in this case is ongoing and, as any new material is developed by~~ participants in this case, and as my investigation continues, my opinions may change and grow. I reserve the right to augment and revise my findings as my work and assignments continue.

SUMMARY OF OPINIONS

9) I was asked to evaluate and address, as an economist, antitrust issues in this case, and the role of price in the use and abuse of alcohol. In this report I review the historical background and rationale for the current statutes, what the existing Washington State statutes relevant to this case look at and require, and the structure of the statutes as to support or requirement for concerted action by market participants. I then address the essence of the 21st amendment, its historical setting, rationale and goals and how existing statutes serve to achieve those goals. The theory of social costs and benefits receives special attention, followed by a detailed description of social costs modified or eliminated and benefits achieved by the current statutes. The public and market benefits (value added) of the three-tier distribution system as it has evolved during the period these statutes have been in existence are also summarized and presented.

10) It is my professional opinion as an economist that nothing in the current statutes permits, requires or facilitates concerted action or causes participants in the beer and wine marketing industry to act in any way other than independently. This conclusion is based on my examination of the statutory and regulatory system and the real world activities of distributors and suppliers as they operate under this system. Moreover, as an economist I find the goals of the system established by these statutes are in fact met. The net impact of the beer and wine regulations is raised prices and controlled access; both are goals of the regulatory scheme, as discussed below.

In its real life operation, the statutory and regulatory process governing the distribution and sale of beer and wine impacts independent market decisions much the way a speed limit impacts drivers' speed. When a speed limit is imposed by the legislature, for whatever societal goal, drivers end up driving at similar though not always equal speeds, but arrive at that speed by making individual decisions with no concerted action.

Similarly, when milk was required to be pasteurized (because of the social costs caused by unpasteurized milk), costs and prices went up similarly for all participants in the market as they reacted individually to the new rule. The goal of the new societal regulation was achieved without producers and distributors meeting to decide how much the increase would be or otherwise acting in concert, but with the market determining the amount of the impact on the cost and price of milk.

That is, in my opinion, precisely analogous to the impact of the challenged regulations on the prices of beer and wine in Washington. There is nothing in the statutes that requires, permits or facilitates collusive or concerted behavior. Rather, given the regulatory structure I as an economist would expect every firm in the market to act independently. Because the firms are all constrained by the same factors they reach similar decisions, but I have observed nothing to indicate that these firms are not acting independently. The similarity of pricing and marketing decisions is entirely consistent with the purposes of the regulatory system and not in any way inconsistent with the concept of independent decision-making.

Genesis of Washington's Regulatory System

11) It was a monumental undertaking on the part of the states, including Washington, to shape a distribution system for alcohol and other products after a period of Prohibition. The State of Washington, like the entire nation, was at that time searching for a means to institute orderly marketing and other goals. The three-tier distribution system was accepted in many states of the nation as the vehicle to achieve these goals.

As prohibition ended, the goals of restructuring were varied but included elimination of bootlegging (the sin of the Prohibition era), elimination of illegal alcohol sales and the attendant loss of taxes to states and the nation, and elimination of illegal production. The Women's Christian Temperance Union and the Anti-Saloon League were still potentially strong, enough so that the breweries did not want to see the return of the "saloon" and its social ills that might bring down the ire of these groups, so regulation was found to be more acceptable to producers. The overall societal charge was, "People want to drink, how should they do it and how should it be regulated?" The purpose of the 21st Amendment was to allow each individual state to answer these questions with a structure best representing the desires of the citizens of that state.

The overall atmosphere of the nation as reflected, for example, in the National Recovery Act, resulted in the acceptance and encouragement of the three-tier distribution system in various industries, where producers were distanced from retailers by the functions performed by the distributors. This was particularly important with respect to alcoholic beverages, where a balance needed to be struck between prices high enough that consumption was not encouraged and prices low enough that bootlegging was not feasible. A system was to be installed where producers did not unduly influence retailers and retailers did not unduly influence producers.

The specific goals underlying the Steele Act in Washington were the continuance of temperance, fairness amongst the participants in the marketing system, orderly marketing and the generation of tax revenue. The State's regulatory system was adopted in the context of the historical experience of the depression, the National Recovery Act and subsequent related legislative actions, and the developing concepts of fairness underlying laws such as the Robinson Patman Act. As an economist, I see all these actions as a search for a balance between competitive benefits and monopoly power outcomes. The search was particularly important for alcohol, with its many broadly acknowledged social costs.

Thus, the current distribution system is designed to incorporate public and private costs, and to strike a balance between full recognition of all such costs and reasonable access to alcoholic beverages for the public. It is not designed to minimize consumer prices. Because of the social costs that had brought on Prohibition, and that are still inherent in the use and abuse of alcohol, it is evident that with respect to alcohol the lowest cost for the consumer is not the lowest cost for society.

Washington's Regulatory Structure and Its Goals

12) The overall operational approach by the State of Washington was to impose some constraints on the unfettered competition that had brought on Prohibition in the first place. The current system is designed to use the three-tier distribution system to achieve the goals identified above. Within the system are a number of different components banning quantity discounts and the granting of credit and

mandating delivered prices, uniform prices and the minimum markup. The statutes are designed to achieve the goals discussed above, using the "post and hold" mechanism as one of the principal enforcement mechanisms.

I have read the statutes, interviewed distributors and others in the state and examined the appropriate written material; I see independent decisions being made, decisions that are constrained by the state's regulatory system. The statutes neither require nor encourage concerted action in the market place but serve to allow decisions to be made in the context of profit maximizing for the firm in a constrained competitive environment.

This is a belt and suspenders system where the components of the system back each other up in achieving the overall goals of the system. While it might not have been unreasonable for the legislature to adopt only one or some smaller number of these regulatory provisions, it chose instead to rely on a collection of provisions that are significant standing alone but also reinforce each other. Individually and collectively, the separate provisions of the regulatory system make the overall goals of the legislature more achievable. They promote uniform pricing and a floor on prices. The requirement that prices be posted and held for 30 days is an enforcement mechanism that makes the other provisions of the law more enforceable and more effective.

The essential questions, again, are just what was the state trying to do and does this system further those goals. Temperance, orderly marketing and fairness in the market place were desired by the Washington legislature, just like the legislatures in virtually every other state, after the experiences before and during Prohibition. The desires to stop the breweries from controlling and forcing the actions of the retailers, and to make alcohol more expensive and access to alcohol more tightly controlled, were addressed by the various statutes, principally by the uniform pricing statute. The multiple constraints added by the state are different in approach but even with this complexity of regulations, no concerted action is required or permitted by the State in the market system and none has been observed by me.

The ban on credit sales and quantity discounts grew out of the "tied house" laws that prohibited suppliers and distributors from giving anything of value to retailers. As an economist I recognize that credit sales and quantity discounts are potentially of value to retailers, and thus the prohibition does operate to keep retailers from receiving a benefit from distributors. As an economist I also recognize that outlawing quantity discounts minimizes the power of the larger brewery or retailer and makes similar costs/prices available to the entire market (a constraint). Nonetheless, the decisions as to the initial price of any particular item are made by the individual producers (competition). The resultant prices are not so high as to guarantee profits for the firms in the market nor are they so low as to encourage destructive competition, such as using alcohol sales as loss leaders in a competitive situation. Similarly, mandating cash sales also restrains influential producers or retailers from using credit to reflect market power, allowing fairness while again not setting any prices in the marketplace. The producers continue to set their individual prices.

The minimum markup similarly affects everyone in the market equally by insuring that low prices, due to volume or market power, would not be over-used in the market (a major goal of the regulatory structure). It affects everyone, similar to the speed limit, but simply allows prices to be set knowing that costs of operation in the market would at least be minimally covered. The initial price, against which the markup is charged, is still individually determined. I have looked at businesses in many studies and in this industry, and a 10% markup does not come close to covering the costs of doing business as a distributor, much less guarantee profits. In fact, for some of the distributors the inventory costs alone could well be more than 10% of purchase prices.

Fairness and a level playing field, no bootlegging and reasonable access to the product in all geographical areas are the goals of the uniform delivered price. The result of this constraint is an equal price irrespective of location, but based on the original individual price basis from the supplier or distributor, a price that is determined without the State either requiring or permitting concerted action. These prices are equal to all customers of a single seller but are not held equal among different sellers.

Finally, the post and hold requirements allow government inspection and accountability on the part of the participants in the system. They are an effective way to enforce the 10% minimum markup requirement and uniform pricing. The posting of the prices is the principal vehicle for effective enforcement of the minimum markup requirement. The "hold" on prices is the principal vehicle for enforcement of uniform pricing, the ban on quantity discounts, the ban on credit sales, and other "tied house" provisions. The "hold" also facilitates orderly marketing, avoiding the drastic swings in product price that bring about over- and under-orders, returns, consumer uncertainty, etc. The time requirement appears to fit the cycle time for all customers to be able to order, receive, sell and assess their products' performance. This cycle is imposed by the State, but prices and product offerings are determined by each individual firm's assessment of market conditions. The effect is to generate sufficient stability of supply and demand in the market so we do not witness drastic price decreases as firms attempt to clear the market by selling off surpluses.

13) It is evident to me, as an economist, that the goal of this system was not to increase profits at various stages of the supply chain in the market. Rather, the goal was and is to allow as many costs, public and private, to be considered in the consumer's consumption decision as possible, while providing for the orderly marketing of those products and eliminating the incentive of the participants to go outside of the regulatory scheme.

Economists often evaluate the performance of a system by projecting the impacts of not having the system in place. In that context, the principal issues to address are assessing what impact eliminating these constraints would have on abusive beer and wine consumption and on the marketing of beer and wine, and assessing the social costs of unequal opportunity.

As an economist, I would expect the marketing structure that would arise from elimination of the challenged restraints to have a number of adverse consequences. Allowing quantity discounts and granting of credit would have the effect of lowering prices to those consumers who can shop at big box stores, with attendant increases in quantity consumed and an increased opportunity for abuse. Eliminating the ban on quantity discounts and credit sales would also raise the specter of reemergence of the "tied house" saloons and related problems, because the result would be increased pressure on market participants to increase volume movements and an attendant increase in abusive consumption.

Without these and other uniform price requirements, outlying areas, currently cross- subsidized under the existing system (just as electricity, phone service and other public utilities are subsidized), would see a significant reduction in services available to them or would see price, product or both severely restricted. Since some people would have their access to alcohol dramatically curtailed, there would be a strong incentive for illicit manufacturing or sales activities, and abusive behavior is associated more often with such activities than with lawful consumption.

Further, the larger chain box firms would gain and the smaller mom and pop stores would be at a definite competitive disadvantage. If the role of distributors were to be diminished, smaller retailers would be disadvantaged in several critical ways. As will be shown below in my discussion of the role of the distributor, inventory costs could be shifted to the smaller retailer, the ability of new smaller wineries or breweries to get shelf space would be decreased, product quality, product price and product alternatives would be limited, overall quality of service would be constrained, and other similar size-related impacts could be expected.

Elimination of the minimum markup would allow variation of price on identical products, while giving up some control at the distributorship level as they fight against large breweries. Loss of the "hold" on posted prices would introduce price variability and uncertainty into the market, with more chaotic marketing. Elimination of the post requirement would make enforcement significantly more difficult, since the regulators would only have access to prices by actually going into the premises of producers and distributors.

All of the above-described outcomes would be expected to result from elimination of the constraints in the current distribution system. None of these outcomes correspond with the acknowledged goals of these regulations. Therefore, as an economist I believe the current system significantly furthers the State's goals of orderly marketing, encouraging temperance, fostering fairness amongst the participants in the marketing system, and generating tax revenue.

Social Costs Background

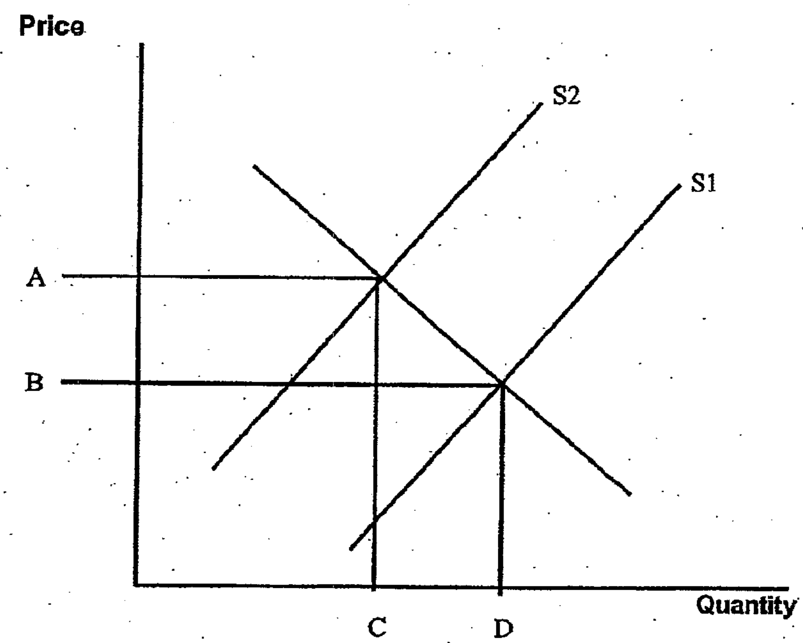
14)) My review of the Washington regulatory system for beer and wine distribution indicates that the system was and is designed to foster vigorous competition above a price floor. That floor is raised by statute to reflect the social costs inherent in consumption of alcohol more accurately than would be the case in an unregulated market (similar to power plants being forced to put in scrubbers on their towers due to the social costs, even though private costs of operation are increased). Bringing social cost into the market place will inevitably cause some individual firms to complain that they are constrained, which is the essence of this case. Such firms feel they are prevented from maximizing individual firm profits. Barring sales of alcohol to individuals below 21 years of age or to visibly intoxicated individuals prevents sellers from maximizing their individual firm profits, yet that does not justify abolishing those limits. Unless public costs are part of the consumers' decision we will see the market operating at a price and quantity that is not socially optimum; as firms pursue private profit, we will see increasing social costs borne by the public.

Figure 1 indicates the private and social supply curves, along with a traditionally shaped demand curve, that conceptually hold in the market. The supply curves are based on the costs of providing the product to the market. S1 indicates only those costs incurred by the brewer or vintner in the physical production and marketing of the product. S2 includes those costs, but also includes the social costs of drunk driving and its attendant car accidents and fatalities, the health effects of excessive drinking, and suicide, violence on campus, and other adverse consequences associated with irresponsible alcohol consumption. These costs are almost always borne in large part by the public.

When only private costs are considered the price B and quantity D are witnessed in the market. As social or public costs are factored into the consumer's decision, in addition to the private costs, the quantity demanded by the consumer decreases to quantity C as a result of the higher price. Thus, an equilibrium with a higher price and a lower quantity consumed in the market is socially appropriate. The public costs, detailed below, are real impacts from the excessive or irresponsible consumption of alcohol, and cause the market price to be higher and consumption to be lower. Since these costs are borne by the public, anything that causes the consumer to consider social costs in private decisions results in greater true market efficiency, one that reflects the full cost of resources consumed by an action.

The numerous public costs of alcohol abuse include the following: drinking and driving and attendant accidents and deaths; drinking by our youth and young adults; the addictive nature of alcohol; the health effects of liver cirrhosis; accidents at work; suicide; child abuse; spousal abuse; rapes and robberies; and violence on campuses. My review of the literature has convinced me that there is little or no doubt that price and availability have a negative effect on consumption and abuse of alcohol.

Figure 1. Private and Social Market Determination



Price and Alcohol Consumption

15)The most consistent law of economics is the law of demand, namely that as the price of a commodity increases, the quantity demanded of that commodity will decrease. Beer and wine are not exceptions to this universal truth. Thus, any action (banning of quantity and credit discounts, taxes, licenses, etc.) that increases the price of beer and wine products at retail will have a dampening effect on the consumption of those products, thereby decreasing the adverse effects of their consumption. Economists describe this as a function of price elasticity.

Price elasticity measures the responsiveness of quantity demanded to price. That is, it identifies the percentage change in quantity consumed as a result of a specified change in price. Typically, price elasticity is measured in terms of the percentage change in quantity demanded, or consumption, resulting from a 1% change in price. The literature settles on estimates of –0.3, -1.0 and –1.5 as price elasticity estimates for beer, wine and liquor, respectively (Leung and Phelps, Nelson, Kenkel 1993 and 1996, Manning et. Al.). This means that a 1% increase in price will result in a decrease in the quantity demanded for beer by .3%, a decrease in the quantity demanded for wine of 1%, and a decrease in the quantity demanded for spirits of 1.5%. Authors in the literature do comment that these estimates can vary depending on study design but these estimates reflect a consensus of the literature. All three elasticity estimates indicate a significant, though varying, response to a price change.

Price, Alcohol and Social Impacts

16) Prices affect the consumption of alcohol by youth and young adults, with a decrease in drinking and driving at all ages (Chaloupka, et al., Kenkel, Chaloupka and Laixuthai, Mast et al, Saffer and Grossman, Ruhm, and Dee and Evans), a decrease in disease, a decrease in driving injuries, a decrease in deaths (Dee and Evans, Grant et al., Rachal et al) and a decrease in violence (Cook and Moore, Markowitz and Grossman, 1998 and 2000, Markowitz, Grossman and Markowitz, 2001, Saffer). Other studies indicate a decrease in both drinking and heavy drinking as a result of increased costs of alcohol to the consumer (Grossman et al, Laixuthai and Chaloupka, Chaloupka and Wechsler). Increased fines (and a lower allowed legal level of intoxication while driving) for underage drinking and driving result in decreased consumption (Grossman et al.). It should be noted that in this instance the youth are considering the full cost

of their consumption (money spent on alcohol plus the probability of legal exposure to fines), and making different decisions as a result. The costs of time spent in acquiring the alcohol is also found in studies to affect consumption (limited bar-times, decreased happy hours, server training in bars, etc.) My review of the extensive literature on these issues indicates that price increases cause a decrease in consumption among current drinkers in the aggregate, and in the number of drinks by existing drinkers, reduced availability and experimentation among potential but currently non-drinkers, and reduced relapse by former drinkers.

Many different types of costs are associated with the abuse of alcohol. Automobile accidents are the leading cause of death for people less than 35 years of age and alcohol is a contributory factor in 50% of those instances (Dee and Evans, Dee). Due to the addictive nature of alcohol (Becker and Murphy), if consumption can be decreased today, we do see some decrease in future consumption and abuse as well. The long run elasticity of demand is greater, -0.65, than the short run elasticity, -0.29, as a result (Grossman et al). Studies consistently show that as the price of alcohol increases, the number of automobile fatalities decreases, the same way that tough, enforced laws decrease the incidence of drinking and driving (Chaloupka et al). Studies also show the decrease in liver cirrhosis with a price increase (Cook and Tauchen, Grossman), indicating that even the addicted respond to price.

Performance of the Three-tier Distribution System

17). Under Washington's three-tier system consumers must purchase alcoholic beverages from *licensed* retailers, retailers must purchase the item from *licensed* wholesalers, and wholesalers must purchase them from *licensed* manufacturers. When the legislature chose to support the three-tier system it placed value on the existence and role of the distribution system, namely the distributors in the market. My knowledge of marketing, my review of marketing studies and my extensive interviews in connection with this assignment have reinforced the common knowledge of the benefits and value created by beer and wine distributors. First, and perhaps most important from the viewpoint of the framers of the legislation, is the separation of producers from the retailers in the marketing channel. The absence of such separation was a principal source of many of the undesirable results leading to Prohibition. This balance of market power and the lack of "tied houses" result in individual company decisions that, while still focused on a desire for volume sales, are now forced to take into account some of the social costs of alcohol consumption.

Vertically integrated industries, operating without independent distributors, lead to brand-building efforts such as excessive advertising and provision of additional services, again in an attempt to increase volume consumed. Contrast that to the results of this slightly constrained market where transactions are far more open and accountable. The post and hold also cuts back on price volatility, with fewer volume-inducing sales and price promotions in the short run, leading to more orderly marketing.

Distributors provide a vast array of potential services at all stages of the supply chain. Distributors rotate product on the shelves, and when reasonable refrigerate it. Distributors can take old beer back, throwing out the old and absorbing the loss. Distributors, rather than retailers, often carry the risk of experimental varieties or products that may be rejected by the consumer, allowing some new product development and testing to occur in the market. Many more wine labels, and therefore smaller wineries, are carried, inventoried and made available to the consumer by the distributors. This is possible because the larger companies can afford to carry an expensive inventory, even for wines that are often sold only by the bottle. Important to the goals of the statutes, the distributors collect and return taxes efficiently. In sum, without the regulatory structure we could end up with a system that would be "efficient" if viewed purely from the view of private, profit-maximizing firms but that would almost certainly not maximize societal benefit and would not be a "fair" system.

18) There is obviously a disagreement between Costco on the one hand and the State of Washington and beer and wine distributors on the other as to the balance to be struck between the operational efficiency of this one large retailer and the public costs that are not addressed by, and may well be exacerbated by, that efficiency. I cannot, as an economist, choose the level of public costs to be considered by the legislature but it is patently obvious that these costs are real and are imposed on society as a result of alcohol abuse. It is the role of the legislature to make those policy decisions; the economist only informs as to the type and magnitude of efficiencies and the public costs and benefits that should be considered in that trade-off decision.

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The following is a list of people I have interviewed in the course of my work on this case. I believe this list is complete, but if I discover that others have inadvertently been omitted from this list I will supplement it.

1. Ted Rusnack and Tom Wold
   King Beverage, Inc., Spokane;

2. Fred Bevegni
Western Beer Distributors, Inc., Sumner

3. Mike ("BJ") Bjorke, Dave Devoe and Laura Bennett
Black Hills Distributing Company, Tumwater

4. Dick Loeb, Steve Loeb and Bob Stevens
Alaska Distributors Co., Seattle

5. David Rees and warehouse staff
The Odom Corp, Spokane

6. Paul Shipman
Red Hook Brewing Company, Woodinville

7. Lonnie Schott
The Grape Escape, Bellevue

I have participated in two conversations with Bill Rorabaugh (University of Washington) and I rely on information gleaned from him in formulating some of my opinions and conclusions. In addition, I have had informal discussions with a number of distributors, wineries and others in the industry. None of these were formal interviews, and I do not have notes of those discussions. Although there is nothing in any of those informal discussions that I can specifically say I relied on, collectively they reinforced my understanding of the industry, its operations, and the regulations at issue in this case.

CERTIFICATE OF SERVICE

I hereby certify that on the 3 day of June, 2005, I electronically served the foregoing to the following: David J. Burman, dburman@perkinscoie.com; David M. Hankins, davidh1@atg.wa.gov, and Michael D. Sandler, mike@sandlaw.com

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